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PORTFOLIO WATCH

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Fee Only

God as an Investment Advisor

Imagine if you could perfectly predict stocks over the next 5 years. Somehow, you are able to look into the future to see which stocks will do the best, and then buy those stocks today. You would be rich. You would be very popular. In fact, you would need to be God. And you would still get fired as an investment advisor.

Long-term Returns Don't Help

The research for this comes from AlphaArchitect. They peered 5 years into the future to look at the stock returns for the 500 biggest companies, beginning in 1926. With this perfect, God-like foresight, a portfolio was then put together with the 50 stocks that would perform the best over the next 5-year timespan. The process was repeated every 5 years until 2009. Although many people like to look at stock charts and say "why didn't we just buy here and sell there," this was an actual chance to do it in 5-year chunks. If an advisor had this ability to see perfectly into the future, they should be the most successful advisor ever, right? Nope.

Perfect 5-year Stock Portfolios

By choosing the best stocks with perfect accuracy, we would expect losses to be kept to a minimum. It turns out the worst monthly loss was -32.7%, and the worst peak-to-trough drawdown was -76.0% (1929-1932). OK, that was the Great Depression. What about modern times? Still not great. Loss from 3/31/2000 to 3/31/2001 was -34%; 13 percentage points worse than the S&P 500. God likely got fired. Loss in 2008 was -42%, or about the same as the S&P 500. 1980-1981 was 10 points worse than the S&P (fired again). Over the entire timeframe, the average growth for the portfolio was 29%, which is incredible, but in the short-term it was often not any better or even worse than the market.

The Ultimate Hedge Fund

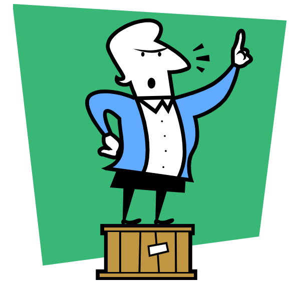
If you had this ability to look into the future and were not content with just buying stocks, you may want to create a hedge fund that also shorted the 50 worst-performing stocks. How did God do with his long-short hedge fund?

	Best Hedge Fund	S&P 500
Average Return:	**49.24%**	9.63%
Worst Drawdown	-59.99%	-84.59%
Worst Month Return:	**-44.44%**	-28.73%
Best Month Return:	26.43%	41.65%

So fantastic overall returns, but can still be volatile in the short-term and has periods where it underperforms the S&P 500 significantly. In fact, in 2009 this perfect hedge fund, which trounces the market over the long-term, was down 42% when the market was up 40%.

Conclusions

I think we can conclude that even a perfect 5-year portfolio, with God managing it, will have periods where it underperforms the market. This will be unacceptable to many investors. The more practical conclusion is that any active or risk-managed strategy, or pretty much anything that deviates from the overall market must have a long-term time horizon. I think 5 years is the minimum. Being non-correlated does not mean "always beats the market." If you use the S&P 500 as your measuring stick, then the best bet is to buy an Index fund and be done with it. If you want something that actually correlates with your financial goals AND beats the market month-to-month, even God would have a tough time doing that.



Market Comments

For only the second time in 10 years, I missed writing my newsletter last month. Between tax deadlines, end-of-quarter activities, business growth and ballroom dance lessons, there just wasn't enough hours in the day before I ran out of motivation. Just like last time, I have heard and seen enough ridiculous things in the market over the last 2 months that it's difficult to pick just one to write about.

The stock market is basically directionless right now, and is a little more than 4% down for the last 12 months. A little disturbing to me is that the last 2 high points in the S&P 500 have been a little lower than the one before, and having lower high points is not a good sign (investors are deciding to sell earlier and earlier). I'm not sure what would make the market enter another bull cycle over the next several months. "Sell in May and go away" is kind of a rule of thumb because the summer tends to be a weaker time for stocks, and it's anyone's guess how the two presidential choices will affect stocks. The market doesn't like uncertainty, so I don't see a lot of optimism suddenly taking over investors. One thing nice about having income as the core of a portfolio is that progress can still be made in flat markets.

I've been having a lot of conversations lately with Intel employees about early retirement and what to do about it. Because there have been so many questions about how to invest while also limiting risk, and because I've added quite a few new clients lately, I put together a video called "Investing Like an Endowment" that walks through my high level strategy for investing and why I put together portfolios the way I do. I'll be sending it out soon and I think it will be useful for new clients, those who are thinking about being clients, and those who have been clients for a long time. If you want to see it early, the video can be viewed at https://youtu.be/mBmgaDsU94Q.